

**"Patience is bitter, but its fruit is sweet."
Jean Jacques Rousseau, Swiss Philosopher (1712-1778)**

"Bitter" is probably a suitable word to describe the investment markets in 2008. Most investment classes, including domestic and international stocks, as well as corporate bonds, saw the worst losses in several decades in the past year. As the chart below shows, there were relatively few sectors that didn't see double-digit losses for the past 12 months:

Index	Category	2008 Return
S&P 500® Index	Large U.S. Stocks	-37.0%
Russell Mid Cap® Index	Mid-Sized U.S. Stocks	-41.5%
Russell 2000® Index	Small U.S. Stocks	-33.8%
MSCI EAFE® Index	International Stocks	-43.4%
Barclays Cap. High Yield Idx	High Yield U.S. Bonds	-25.5%
Barclays Cap. Corp. Idx.	U.S. Corporate Bonds	-3.1%
90 Day U.S. T-Bills	Short-Term U.S. Bonds	2.2%

The past year has been a historic period for the world's investment markets. We have seen the collapse of a few of our country's most prominent institutions: the sale of Bear Stearns, the federal government taking over Fannie Mae and Freddie Mac, the sale of Merrill Lynch, the bailout of AIG, and the bankruptcy of Lehman Brothers. In addition, we have seen the demise of nationally-known banks such as Wachovia and Washington Mutual. What would have seemed implausible just a year ago has become a reality in a very short time. However, all of the historic events we have seen in the past few months have been caused by a fairly common occurrence: a failure to lend and borrow money responsibly.

During the past several years, really until early 2007, the U.S. saw a tremendous increase in both the number of homes purchased and the market values of those homes. Historically low interest rates, coupled with adjustable-rate and interest-only mortgages, provided many households the opportunity to purchase homes that would have been outside their means at higher rates. Mortgage lenders, buoyed by the "fact" that home prices increased in value every year, were happy to accommodate these borrowers, thinking that even if the home was foreclosed on, they would be able to sell it for an even higher price. However, as interest rates began to increase and, accordingly, adjustable-rate mortgage payments began to increase; many households were unable to afford their payments. As a result, foreclosures began to escalate. As foreclosures increased, home values began to decline in many areas and the mortgage lenders were stuck with properties that they could not sell.

In the past, this is where the chain of events would have stopped for the most part. The homeowners who borrowed too much money lost their houses and the lenders who lent them too much money were stuck with properties they would have to sell at discount prices. However, as I am sure most of you are aware, over the past couple of decades it has become common practice for lenders to sell the mortgages to other entities, such as investment banks. These mortgages are then bundled into mortgage bonds or derivatives of those bonds and then sold to investors such as pension providers, foreign governments, mutual funds, etc. Therefore, when over-extended homeowners can't pay these mortgages, the problem isn't just contained to the original lenders. The losses are spread out among a large number of investors, so a much greater number of people suffer.

Among the hardest hit of these sufferers are the commercial and investment banks. Because of some regulatory changes in the past 10 years, banks were allowed to invest in a large number of these mortgage derivative investments. In 1999, the President and Congress repealed the Glass-Steagall Act. This Depression-Era law limited the types of investment activities in which commercial banks were allowed to engage. The repeal of this law opened the door for commercial banks (such as Citigroup, Wachovia, Washington Mutual, etc.) to deal in several types of investments that had been closed to them before, including "collateralized obligations" such as mortgage bonds. Also, in 2004, the SEC allowed an exemption to the Net Capital Rule for large investment banks. What this did was give several big investment banks, including Lehman Brothers, Goldman Sachs, JP Morgan, and Bear Stearns among others, the ability to increase the leverage on their balance sheets dramatically. Put simply, it allowed these investment banks to borrow money in order to purchase other securities, namely mortgage-based derivative securities. Soon after the repeal of this rule, Bear Stearns, for example, increased their leverage ratio to 33 to 1; meaning that for every \$1 of equity the company had they held \$33 of debt. Leverage, as many people know, is a double-edged sword; it dramatically increases returns in good markets and dramatically decreases returns in bad markets. When foreclosures began to increase, these over-extended investment banks didn't have sufficient capital to cover their obligations and the government was forced to step in to help.

Therefore, what has historically been a problematic situation for a contained number of people and businesses (the original borrowers and lenders) has taken on a much larger scale and has affected millions of others. This strain on the financial system, and the fear of its potential consequences, has been the biggest reason for the losses we have seen in the equity markets this year.

Unfortunately, the losses weren't just contained to stocks. As investors began to see these events unfold, there was widespread concern that the credit problems facing the U.S. financial system would affect individual corporations' ability to repay their bond holders. As a result, many investors began selling their corporate bond holdings and seeking the safety of U.S. government instruments. Depending on the credit quality of your bonds, you could have seen a slight gain (4% for AAA-rated bonds) or a substantial loss (-28% for high yield bonds).

In addition to the credit problems we have discussed, investors are now facing the added problem of a recession in the U.S. economy. Early in December, the National Bureau of Economic Research released its findings that the U.S. economy has been in recession since December of 2007. While recessions are quite common, it does present yet another set of worries to equity investors who have seen sizable losses in the past year.

So, as we enter 2009, investors have several questions lingering from 2008 that are, as yet, still unanswered: Are all of the sub-prime and credit issues behind us? When will banks once again have the ability to lend money to consumers on a continuous basis? How long will the recession last and how deep will it get? While it will take some time to determine the answers to these questions, we continue to remind participants to take a long-term view to their assets. Your account is intended to be a benefit not only *until* retirement but *through* retirement. Therefore, even those participants in their 50s and 60s could possibly be considered long-term investors. History has shown that the U.S. economy is extremely resilient and has time and again bounced back from recessions and downturns in the markets, and we have no reason to believe this time will be any different. As bitter as it can be, it just takes a little patience.

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